A New Normal for Portfolios: Construction, Assessment and Evaluation

Jeffry Haber
Iona College

The financial crisis found many investors questioning what went wrong and how they might structure their portfolio going forward to avoid similar catastrophe. Such re-examination has led to new buzz-words and what seems like new paradigms. An example is the new normal. Other frequently seen headlines deals with whether the endowment model is broken. This paper looks at the investing issues in portfolio construction, assessment and evaluation in terms of the "new normal" and the "broken endowment model" and finds that the new normal is no different than the old normal and the endowment model is actually the blind following and replication of a few industry leaders. Despite the ample rhetoric, nothing much has changed or will change.

INTRODUCTION

When the financial crisis began, it began slowly. At first it was sub-prime lending that collapsed, then prime credit, then the equity markets, the international markets and culminated in a world-wide liquidity crisis where there were ready sellers and no buyers. The crisis lasted roughly 16 months, from December 2007 through March 2009. During this period virtually every asset class, save government bonds, had periods of severe impact. Once the dust had cleared institutional investors began assessing their portfolios and developed a strategy for changes to better incorporate the previously unanticipated risk elements.

At the same time, consultants, fund managers and others began developing a new set of paradigms to capitalize on the institutional investors' travails. This includes "the new normal" and the "broken endowment model." Well how new is the new normal and how broken is the endowment model?

WHY INVEST

Every institutional investor that has a portfolio has to ask themselves "why should we invest?" The answer, most likely, will be to enable the organization to carry it outs mission. It is therefore incumbent on the organization to develop a set of policy statements surrounding how it will invest its endowment (the investment policy) and how it will spend its endowment (the spending policy). Both of these statements are required by most enacted versions of UPMIFA (Uniform Prudent Management of Institutional Funds Act).

Most investment policies boil down to two statements:

- Goal of perpetuity
- Goal of a real, X% return

The "X%" will be determined by the organization – private foundations have an annual 5% payout requirement, so they will usually add some element for expenses and taxes above the 5%. Spend-down organizations will not have a goal of perpetuity, so their investment policy statement might look very different.

Some investment policy statements contain additional language, some about risk (which usually does not help the investment process since it is typically a vague statement) and some organizations have a socially responsible investing policy ("we won't invest in companies that produce, manufacture or distribute cigarettes" for example) that screens out certain companies and funds, while others have a policy that screens in certain companies and funds ("we will invest in companies that produce clean energy").

So the short answer to "why invest" is contained in the investment goal – if you need a real return above some percentage and your goal is perpetuity, holding just cash won't cut it.

RISK PARAMETERS

Many organizations and funds talk about risk, but few understand what risk is or how it will affect them. Risk is a multi-attribute factor that takes on many different forms. Is risk:

- Quantitative or qualitative
- A noun, verb or adjective
- Subject to a normal distribution or some other distribution

In some cases risk is quantitative (VaR, or value at risk, the measure of how much of the investment can be lost in a single day) or qualitative (headline risk, or the risk of adverse publicity). Often, individuals discussing risk are talking about different types simultaneously. That's also what makes quantification of risk impossible[1] – risk is too encompassing a word. Individual elements of risk can be quantified, but not the totality of what risk is.

STRESS TESTING

Funds often tout that they stress test their fund, which implies a quantification of risk and the ability of the fund to handle risk. But stress testing is really adjusting existing parameters, whereas risk is more comprehensive. Donald Rumsfeld once said (and I paraphrase):

There are known knowns,
Known unknowns and
Unknown unknowns.

There are the things we know that we know, and there are the things that we know that we do not know. However, there are things that we do not know that we do not know, and therein lays the elements of risk. The "unknown unknowns" by definition cannot be incorporated into a model except by a surrogate, such as a random or noise factor. What amount should be incorporated? A good start would be to take the stress tested funds and look to see that actual performance – the difference between the stress test NAV (net asset value) and the value at the bottom would be the noise factor. Going forward, incorporating this amount and publishing it may make the fund unsalable, but intellectually honest.

CORRELATION

Often, investment opportunities are described in ways that appeal to investors, rather than in ways that are factually correct. There are an incredible number of funds that "do not correlate" with other investments. Non-correlation is a desired feature for certain investments, and funds take advantage of this by billing themselves as uncorrelated, even if the period of non-correlation is an extended duration.

Investors are sometimes careless in describing non-correlation, confusing it with negative correlation. Correlation is a statistical measure of the predictability of the future movement of one stream of data given the movement of a second stream. The greater the correlation, the better the predictive accuracy. Correlation ranges from -1.0 to +1.0. A correlation of -1.0 is exactly as strong as a correlation of +1.0, but is an inverse relationship (as one stream goes down, the other goes, up, and vice versa). A positive correlation is where one stream goes up the other stream will go up as well[2].

Non-correlation (or uncorrelated) is some specified amount around zero. Investors and fund managers are usually not clear about what constitutes non-correlation. My personal preference is to consider high correlation as being +/- .70, low correlation as +/- .20, with the range in-between being whatever comes between low and high[3].

THE MARKET GOES TO 1

In times of financial stress there can be heard (time and time again) that the "market went to 1." This is used as an excuse for why portfolios lost value; the inherent meaning is that everything went down so there was no place to put funds. Of course, no one ever says that the market went to 1 on the upside, which would imply that the investor had no acumen, they merely followed the trend.

Well does the market go to 1? Theoretically, no[4] and empirically, no[5] as well. It may be convenient to claim the down markets had highly correlated investment options, but even in times of extreme distress there were investment options that were non-correlated. Naturally, no one would suggest that the market literally went to 1, but that phrase is used to mean that asset allocation choices were highly correlated. I considered any correlation at or above +/- .70 as being at 1. During the tenure of the financial crisis (I used the 16 months from December 2007 through March 2009) all developed equity markets (domestic and international) were highly correlated. Emerging equity markets were just under the cutoff (.68) for high correlation (or "going to 1"). Debt markets, both government and commercial, along with commodities were non-correlated, dispelling the well-held notion that the "market went to 1."

PURPOSE OF ASSET ALLOCATION

What is the purpose of asset allocation in an institutional portfolio? Since I hold the belief that risk, on the whole, cannot be quantified (except by looking at very specific characteristics in a singular fashion) there has to be some way for an organization to establish a framework to decide on what constitutes proper investments. Asset allocation is that framework. Used correctly, each allocation grouping (or "bucket") should represent those investments that have similar risk characteristics and are highly correlated. Unfortunately, this is often not the case.

Contemporary asset allocation is done according to the security type and where the investment is headquartered. So the stock of a United States (US) company would be part of the domestic equity allocation. And the stock of a European company would be part of the international equity allocation. If the US company made 100% of their sales (assume it is a manufacturer for the retail market) to Europe, would their risk characteristics be closer aligned with other US companies or European companies? Now assume that the raw materials they use in the production process come from the commodity markets. Are the risk characteristics still closely aligned with US companies?

Now suppose that the European company makes 100% of its sales to the US homebuilding market. Are the risk characteristics of this stock similar to other international stocks or more closely tied to the US and the real estate market? The point being that asset allocation needs to be considered on the basis of how the stock will react, not on where the headquarters of the company is.

Additional considerations need to be factored in as well, such as liquidity. Certain investment types (such as limited partnerships, mutual funds with lock ups, any fund with redemption limitations, etc) may not provide the cash flow needed by the organization when the organization needs it. Allocation has to be done a number of ways on a variety of bases.

BENCHMARKING

Benchmarks are an important part of investment management – it allows the portfolio manager to ascertain whether they made a good hiring choice. The benchmark needs to be relevant to the type of investing the fund manager is hired to do, and the benchmark usually represents the low cost option within that type of investing (i.e., an index fund).

Multi-strategy funds represent a more complex situation and usually require a benchmark that is a combination of the various universes that the manager can invest in. Overall, my experience is that most investors have a good understanding of benchmarking and apply it to fund managers appropriately.

The one area that where I find that portfolio managers leave much to be desired in the benchmarking of the portfolio as a whole, which essentially answers the question of whether the Chief Investment Officer (CIO, or anyone who is charged with the fiduciary duty of managing the portfolio) did a good job. Most overall portfolios are benchmarked against a composite return using a combination of US and international indices, such proportions determined by how the organization allocates its portfolio. I view this as incorrect, because the organization has an investment policy statement that contains a return goal – I believe that this should be the portfolio benchmark. Other benchmarks can be used as well, the evaluation need not be limited to one metric, but the return goal should be one facet of the evaluation.

A CIO who delivers exactly what was asked of him/her by the investment committee should be congratulated. However, with the prevalence of peer comparison, often times an organization that has perpetuity and low risk as guidelines and gets the appropriate return will not feel their performance was adequate when they wind up in the lowest quartile. Organizations need to be resolved in understanding their long-term goals and what that translates to on annual return basis.

MEAN REVERSION

No words have been more overlooked than "past performance is not indicative of future performance." Investors tend to flock to the managers with the current highest returns, thinking that this will continue into the future. I am beginning to think (not supported by any research I have done) that managers with good processes (low turnover, succession planning, etc) who were second quartile in return and the best choices, and those funds that are top quartile are candidates to be sold while at the top. Mean reversion seems to be getting traction as an investing philosophy.

To some extent the basic tenet of mean reversion theory is that with the spate of investment managers in the field there is very little alpha that can be imparted, and that most of the excess return is generated by luck. Luck, whether good or bad, does not last forever, and managers in the top quartile cannot be expected to stay there.

CONCLUSION

If, by the "new normal," we mean that organizations will no longer blindly follow industry leaders with goals and aims that may not be aligned, then there is a new normal. But this new normal is nothing more than having organizations ask what the long-term goals are and what should the portfolio look like in order to reach these goals. Too often investors made decisions based on what others were doing without considering whether it was appropriate for them.

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